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Supreme Court, U.S.
FILED
JUN 3 1992
OFFICE OF THE CLERK

No. 91-1607

In the Supreme Court of the United States

OCTOBER TERM, 1991

KAISER STEEL RESOURCES, INC., FKA
KAISER STEEL CORP., PETITIONER

v.

PEARL BREWING COMPANY, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether leveraged buyout payments are settlement payments for purposes of Section 546(e) of the Bankruptcy Code, 11 U.S.C. 546(e), and thus excluded from certain of the avoidance provisions of the Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1A-26A) is reported at 952 F.2d 1230. The order of the district court (Pet. App. 1H-7H) is not reported.

JURISDICTION

The judgment of the court of appeals was entered on December 30, 1991. The petition for a writ of certiorari was filed on March 30, 1992 (a Monday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In January 1984, the shareholders of Kaiser Steel Corporation, the predecessor company of petitioner Kaiser Steel Resources, Inc. (Kaiser), voted to approve a leveraged buyout (LBO) of the company. The terms of the merger agreement through which the LBO was effected required the owners of Kaiser common stock to tender their shares in return for $22 in cash plus preferred stock in the surviving company. Pursuant to that agreement, Kaiser's shareholders were paid approximately $162 million in cash. Pet. App. 13A.

The Bank of America, Kaiser's disbursing agent to carry out the terms of the merger, was authorized to receive the common stock and to distribute payments to Kaiser's shareholders. Most of the common stock was in the possession of the Depository Trust Company (DTC), a securities clearing agency. DTC tendered the shares to the Bank of America in return for the LBO payments. DTC then transferred the payments to its participants, including brokers and other financial intermediaries. The financial intermediaries, in turn, either disbursed the payments to their customers who were the beneficial owners of the Kaiser stock, or retained the payments in the case of broker-dealers who were themselves the beneficial owners.[1] Pet. App. 13A-14A.

2. Three years later, in February 1987, Kaiser filed a petition for voluntary reorganization pursuant to

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[1] Some shares were exchanged through securities clearing agencies other than DTC, and some payments were made directly by the Bank of America to financial intermediaries and beneficial owners without going through DTC, which stopped handling Kaiser's stock prior to the effective date of the LBO. Pet. App. 14A.

Chapter 11 of the Bankruptcy Code. Subsequently, Kaiser commenced a fraudulent conveyance action seeking to recover the $162 million in payments made pursuant to the LBO. It named as defendants both the financial intermediaries that received the payments as record owners (and then paid the funds to the beneficial owners) and the beneficial owners themselves. The latter group included broker-dealers that held Kaiser shares in proprietary accounts as well as other shareholders. Pet. App. 14A-15A.[2]

Charles Schwab & Co., a broker-dealer acting solely as a financial intermediary, filed a motion for summary judgment arguing that it was not liable because it acted as a conduit for the payments rather than as a transferee. Because the motion was treated as a test case on the legal issues, other defendants intervened and argued, in support of Schwab's motion, that the LBO payments were exempt from avoidance under Sections 546(e) and 741(8) of the Bankruptcy Code, 11 U.S.C. 546(e) and 741(8), because the payments constituted "settlement payments" made by or to a stockbroker.[3] The district court ruled in favor of

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[2] The Securities and Exchange Commission participated in this case pursuant to 11 U.S.C. 1109(a), which states that "the Commission may raise and may appear and be heard on any issue in a case under" Chapter 11 of the Code. The Commission's role is to act as an advisor to the court and it seeks primarily to protect the interests of public investors. Although the Commission may not file its own appeals under Section 1109(a), it may appear as a party in appeals brought by other parties, see Pet. App. 9J n.7, and it did so in the current case.

[3] Section 546(e) provides in pertinent part:

> Notwithstanding sections 544 [allowing trustee to invoke state fraudulent conveyance laws] * * * [and] 548(a)(2) [the Code provision permitting avoidance of "constructively" fraudulent transfers] * * * of this title, *the trustee may not*

Schwab on both grounds. Pet. App. 14A; *Kaiser Steel Resources, Inc.* v. *Jacobs (In re Kaiser Steel Corp.)*, 110 B.R. 514 (D. Colo. 1990) (Pet. App. 14F-16F).

Subsequently, the district court held that the remaining financial intermediaries were also entitled to summary judgment on the ground that the LBO payments made to them were exempt from avoidance as "settlement payments" made by or to a stockbroker, financial institution, or securities clearing agency. Pet. App. 1H-6H. In addition, the district court stated *sua sponte* that it would be appropriate to grant summary judgment to the defendants who were the beneficial owners of Kaiser's common stock. *Id.* at 6H. After briefing on the applicability of Section 546(e) to the beneficial owners, the district court issued an order granting summary judgment to the remaining financial intermediary defendants and most of the beneficial owner defendants. *Id.* at 7H.[4]

> *avoid a transfer that is a * * * settlement payment, as defined in * * * section 741(8) of this title*, made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1) of this title [avoidance of transfers made within one year of filing a petition and with actual intent to defraud].

11 U.S.C. 546(e) (emphasis added). Section 741(8) defines a "settlement payment" as:

> a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade * * *.

11 U.S.C. 741(8).

[4] The district court excluded from its summary judgment order certain former stockholders known as the Jacobs Group. Pet. App. 15A n.2, 1I. That group had owned a large block of

3. Petitioner appealed the district court's decision as to Schwab. The court of appeals affirmed, holding that the payments made by Kaiser pursuant to the LBO were "settlement payments" for purposes of Section 546(e). *Kaiser Steel Corp.* v. *Charles Schwab & Co.*, 913 F.2d 846 (10th Cir. 1990).[5] The court relied on three factors in reaching its conclusion. First, the Court noted that the Code's definition of "settlement payment," as found in Section 741(8), is "extremely broad," and other courts have rejected a narrow definition of the term. Pet. App. 5J-6J, quoting *Bevill, Bresler & Schulman Asset Management Corp.* v. *Spencer Sav. & Loan Ass'n*, 878 F.2d 742, 747 (3d Cir. 1989). Second, the court stated that a broad interpretation "is consistent with the legislative intent behind § 546(e) to protect the nation's financial markets from the instability caused by the reversal of settled securities transactions." Pet. App. 6J, quoting *Kaiser Steel Resources, Inc.* v. *Jacobs*, 110 B.R. at 522. Finally, the court determined that interpreting the term "settlement payment" to include the transfer of consideration for securities in an LBO is consistent with the way "settlement" is defined in the securities industry. Pet. App. 8J-9J.

The court of appeals rejected Kaiser's argument that the term "settlement payment" should be restricted to routine securities trading transactions and should not be applied to LBOs and other exceptional transactions. Pet. App. 9J. The court concluded that "because of the variety and scope of different securities transactions, and the absence of any

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Kaiser stock and had received a payment from Kaiser not to oppose the LBO. See Pet. 3.

[5] The court of appeals' opinion in *Schwab* is *reprinted at* Pet. App. 1J-10J.

restrictions in sections 546(e) and 741(8), it would be an act of judicial legislation to establish such a limitation." *Ibid.*

4. Petitioner appealed as to the remaining defendants in whose favor the district court had granted summary judgment. In light of *Schwab*, petitioner abandoned its claims against the defendants insofar as they acted in the capacity of financial intermediaries. The remaining defendants were, therefore, "shareholders or brokers that beneficially owned the Kaiser Steel shares tendered in connection with the LBO." Pet. App. 15A. The court of appeals framed the issue as whether its holding in *Schwab* that payments made to the financial intermediaries were "settlement payments" under Section 546(e) "should be extended to protect payments made to the beneficial shareholders." Pet. App. 15A. Examining Section 546(e)'s language and purpose, the court held that it should. *Id.* at 15A-23A.

As it had done in *Schwab*, the court noted that the statutory definition of "settlement payment" is extremely broad. The court stated that the "clear aim of the definition is to encompass all 'settlement payments' commonly used in the securities trade." Pet. App. 17A. The court rejected petitioner's argument that Section 546(e) is limited to routine securities transactions, stating that no such limitation appears on the face of the statute. *Id.* at 21A. The court further explained that the Kaiser LBO was in substance a securities transaction in which Kaiser shareholders sold their equity interests for money and preferred stock; the shareholders who tendered their shares therefore received payments in "settlement" of that transaction. Pet. App. 23A. The court concluded that applying Section 546(e) to such payments furthers the policy of that provision to

ensure the finality of securities transactions. Pet. App. 23A n.10.[6]

ARGUMENT

The court of appeals held that the LBO payments made by Kaiser were "settlement payments" within the meaning of 11 U.S.C. 546(e). That holding does not conflict with any decision of this Court or of any other court of appeals. Moreover, the decision is consistent with the plain language and purpose of the relevant Bankruptcy Code provision. Review by this Court is therefore not warranted.

1. As petitioner recognizes (Pet. 11), no other court of appeals has addressed the question of whether LBO payments are "settlement payments" for purposes of Section 546(e) of the Bankruptcy Code. Petitioner nonetheless posits a conflict "[i]n a broad sense" with case law holding that creditors can recover corporate distributions to shareholders that render the company insolvent. Pet. 8-9. None of those cases, however, involved Section 546(e). This case involves the distinct issue of whether LBO payments are shielded by Section 546(e), a provision reflecting Congress's specific determination that securities "settlement payments" are protected from recovery under the Bankruptcy Code's avoidance provisions except in cases involving actual fraud that arise within one year before the date a bankruptcy petition is filed.

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[6] The court of appeals also rejected petitioner's claim that Section 546(e) does not protect a settlement payment made *by* a stockbroker, financial institution, or clearing agency unless that payment is made *to* another participant in the clearance and settlement system. Pet. App. 24A-26A. The court concluded that the plain language of the statute applies to payments "*by or to*" the enumerated entities. *Ibid.* Petitioner does not renew that claim in this Court.

The authorities cited by petitioner do not take that provision or its underlying policies into account.[7]

2. Petitioner argues (Pet. 12-14) that the protection afforded to securities settlement payments under Section 546(e) should be limited to the context of "a market trade where shares and money are exchanged between buyers and sellers" and that it should not be applied to transactions like the Kaiser LBO. There is no basis, however, for construing the term "settlement payment" to apply only in the context of exchanges of securities in open trading markets. The definition of "settlement payment" in Section 741(8) is not limited to such transactions, but applies broadly to a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." 11 U.S.C. 741(8).[8]

The payments involved here fit within the commonly understood meaning of "settlement." Most of the payments at issue were made by a financial institution (Kaiser's disbursing agent, the Bank of America), first to a clearing agency (DTC) and then

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[7] Nor does the claimed conflict (Pet. 11) between the decision of the court of appeals here and the district court decision in *Wieboldt Stores, Inc.* v. *Schottenstein*, 131 B.R. 655 (N.D. Ill. 1991), warrant review by this Court.

[8] Other lower court cases construing the term "settlement payment," albeit not in the context of an LBO, have interpreted the term broadly. See *Bevill, Bresler & Schulman Asset Management Corp.* v. *Spencer Sav. & Loan Ass'n*, 878 F.2d 742 (3d Cir. 1989); *Jonas* v. *Farmer Bros. (In re Comack)*, 124 B.R. 806 (Bankr. C.D. Cal. 1991); *Blanton* v. *Prudential-Bache Securities, Inc. (In re Blanton)*, 105 B.R. 321 (Bankr. E.D. Va. 1989).

by that clearing agency to a stockbroker. The court of appeals properly construed Sections 546(e) and 741(8) in a way that is consistent with the ordinary meaning of the term "settlement" within the securities industry. Pet. App. 18A-20A. The term "settlement" as used in the securities industry refers to "[t]he completion of a transaction, wherein securities and corresponding funds are delivered and credited to the appropriate accounts." Group of Thirty, *Clearance and Settlement Systems in the World's Securities Markets* 86 (1989). See also A. Pessin & J. Ross, *Words of Wall Street* 227 (1983) (defining "settle" as "[i]ndustry term for the completion of a securities transaction (i.e., a buyer pays for and a seller delivers the security purchased to the buyer")). The payments in this case, although made pursuant to an LBO rather than in the course of ordinary secondary market trading, were nonetheless made in exchange for securities and were effected through normal settlement channels. These payments "settled" the Kaiser LBO transaction.[9]

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[9] The clearance and settlement process ordinarily involves three separate procedures: (1) "comparing" trades whereby buyers and sellers agree through their brokers to exchange securities in the public market at a given price; (2) "accounting for" trades, whereby the terms of the settlement obligations—deliver or receive, price and quantity—are established; and (3) "settling" trades, whereby delivery and receipt of funds and securities occurs, in discharge of previously established obligations. See generally Securities Exchange Act Rel. No. 13,163, 42 Fed. Reg. 3916, 3920 nn.54-56 (1977) (describing the clearance and settlement process). While the Kaiser LBO did not involve the first two procedures, which relate to the *clearance* of securities transactions, the Kaiser LBO did involve the third procedure, which relates to the *settlement* of securities transactions.

Moreover, Section 741(8) defines "settlement payment" to include not only a variety of specific settlement payments, but also "any other similar payment commonly used in the securities trade." 11 U.S.C. 741(8). Payments made to shareholders pursuant to the LBO of a public corporation are, at the very least, "similar" to settlement payments made in the securities markets in other contexts. The similarity flows from the fact that the Kaiser LBO entailed the exchange of Kaiser's common stock for funds in a transaction through which the company effectively purchased the stock and the shareholders sold it. The payment made to consummate that transaction is functionally equivalent to a settlement payment.[10]

3. Petitioner errs in its reliance (Pet. 13-14) on the legislative history to support a restrictive reading of "settlement payments." In light of the breadth of the statutory language, and the explicit reference to the "securities trade" as providing the relevant context, see 11 U.S.C. 741(8), it is doubtful that recourse to legislative history is required. See *Barnhill* v. *Johnson*, 112 S. Ct. 1386, 1391 (1992); *Connecticut National Bank* v. *Germain*, 112 S. Ct. 1146, 1149 (1992); *Union Bank* v. *Wolas*, 112 S. Ct 527, 531 (1991); *Toibb* v. *Radloff*, 111 S. Ct. 2197, 2200 (1991). But, in any

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[10] Contrary to Kaiser's assertion (Pet. 17), the LBO payments were not the practical equivalent of dividend payments. The LBO payments were made in exchange for stock pursuant to the terms of a merger that required shareholder approval. Dividends, in contrast, do not involve an exchange and are declared by directors. Moreover, the LBO payments extinguished the interests of the former shareholders in the Kaiser stock; shareholders receiving a dividend usually retain their stockholdings.

event, the legislative history is of no avail to petitioner.

The legislative history of Sections 546(e) and 741(8) does not discuss the intended scope of the term "settlement payment." The general purpose of these provisions, however, is to protect the integrity of the securities clearance and settlement systems by "prevent[ing] the insolvency of one * * * security firm from spreading to other firms and possibly threatening the collapse of the affected market." H.R. Rep. No. 420, 97th Cong., 2d Sess. 1 (1982). Congress sought to promote the liquidity of participants in the securities industry by preventing debtors from invalidating margin, settlement, and similar payments or deposits by using the Bankruptcy Code's avoidance provisions to reverse settled securities transactions.[11]

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[11] An impetus behind these amendments was the fear that the avoidance sections of the Code, as originally enacted, could be construed as invalidating margin, settlement, and similar type payments made by a broker or customer who became insolvent. The amendments were designed to "ensure that the avoiding powers of a trustee are not construed to permit [such securities payments] to be set aside except in cases of fraud." H.R. Rep. No. 420, *supra*, at 2. Beyond the obvious disruption caused by the risk of participants' undoing completed securities transactions, Congress was concerned about the risk resulting from a change in the market price between the time a transaction has been entered into and the time of settlement. *Id.* at 1 (protections are needed "[b]ecause of the structure of the clearing systems in these industries and the sometimes volatile nature [of] the markets"). Often the price of securities can vary significantly in that period. For that reason, participants could be exposed to significant risks in the event that the market moves away from the price at which the trade was made and another participant fails to perform. That particular concern is generally not relevant in transactions such as the Kaiser LBO that involve set prices.

Kaiser argues (Pet. 17-18) that the scope of Section 546(e) should be restricted to the specific problems discussed in the congressional hearings that led to its enactment—the protection of brokers and clearing agencies that stand behind the obligations of an insolvent customer or broker. See *Bankruptcy of Commodity and Securities Brokers: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 97th Cong., 1st Sess. 243-245 (1981). But "[i]t is not the law that a statute can have no effects which are not explicitly mentioned in its legislative history." *Pittston Coal Group* v. *Sebben*, 488 U.S. 105, 115 (1988).[12] While the hearings focused upon the system of guarantees through which the clearance and settlement process operates and the potential harm to the process if payments among participants such as brokers and clearing agencies can be voided because of a bankruptcy, nothing in the legislative history indicates any intention on the part of Congress to exclude payments made to shareholders from the coverage of the statute.

Interpreting Section 546(e) to include payments received by beneficial owners who are themselves part of the clearance and settlement system furthers the congressional purpose of protecting the system from instability attributable to bankruptcies. Allowing recovery from those beneficial owners that are

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[12] Cf. *Union Bank* v. *Wolas*, 112 S. Ct. at 531 (construing the plain language of 11 U.S.C. 547(c)(2) to exempt from certain of the Code's avoidance provisions long-term debt payments made in the ordinary course of business, even though the legislative history indicated only that the provision was designed to address problems of trade creditors and issuers of commercial paper, not the problems of conventional long-term lenders).

broker-dealers or financial institutions could threaten the stability of the clearance and settlement system. It makes no difference whether the broker from whom the payments are recovered was an intermediary for customers or a beneficial owner. The broker would be confronted in either case with the unanticipated need to make a substantial payment and could as a result face a capital or liquidity problem. The broker might be unable to meet its other securities trading obligations. Others in the chain of guarantees could be placed at risk by the broker's failure. The insolvency of a major brokerage firm could mean that a clearing agency would have to draw on its clearing fund, thereby potentially requiring an increase in the clearing-fund contribution from other members to compensate for the added risk due to the insolvency.[13]

3. Petitioner argues (Pet. 21-28) that review is warranted because the decision below has harmful consequences for the creditors of a bankrupt corporation that underwent an LBO.[14] Review is not warranted for that purpose. While protecting settlement payments to shareholders will diminish the funds available for distribution to creditors, that consequence follows from Congress's balancing of the need to protect creditors against the need to protect settle-

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[13] That scenario is also possible, although less likely, when settlement payments are recovered from individual shareholders who are not part of the clearance and settlement system. The system could be implicated if such a shareholder, as a result of the recovery, were unable to meet outstanding trading obligations of such a magnitude that the broker would be affected as well.

[14] The creditors in this case include employees, retirees, and trade and bank creditors, as well as the Pension Benefit Guaranty Corporation.

ment payments made by or to participants in the settlement system. By enacting Section 546(e), Congress determined that settlement payments made by or to stockbrokers, financial institutions, or clearing agencies should be shielded from the full reach of the creditor protections of the fraudulent conveyance laws, with recovery permitted only for transfers that involve actual fraud and occur within one year of a bankruptcy petition. If that scheme results in harm to creditors or others affected by an LBO, the remedy lies with Congress. See *Union Bank* v. *Wolas*, 112 S. Ct. at 533.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JUNE 1992